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OO RUEHAG RUEHDF RUEHIK RUEHLZ RUEHROV
DE RUEHFT #1001/01 0950907
ZNR UUUUU ZZH
O 040907Z APR 08
FM AMCONSUL FRANKFURT
TO RUEHC/SECSTATE WASHDC IMMEDIATE 5488
INFO RUEATRS/DEPT OF TREASURY WASHDC IMMEDIATE
RUCNMEM/EU MEMBER STATES IMMEDIATE
RUCNFRG/FRG COLLECTIVE IMMEDIATE

UNCLAS SECTION 01 OF 02 FRANKFURT 001001

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DEPARTMENT FOR EUR/AGS
TREASURY FOR LUKAS KOHLER/OFFICE FOR EUROPE AND EURASIA

SIPDIS

E.O. 12958: N/A
TAGS: EFIN ECON EU GM

SUBJECT: German Economy Holds its Breath for Financial Crisis to Pass

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¶1. SUMMARY. The international financial crisis has so far had a limited impact in Germany and many analysts contend the EU and emerging markets will pick up most of the slack from lower exports to the U.S. The soaring euro and a continuing stream of write-downs by German banks have shaken confidence in some quarters, resulting in a sustained reluctance by banks to lend to one another. Our interlocutors were reasonably confident Germany would weather the storm, but most acknowledged that continued uncertainty in the markets made it difficult to look beyond the next several months. END SUMMARY.

¶2. In a series of meetings in Frankfurt and Wiesbaden on March 27-28, EMIN, Congen Econoff, and FSNs met with senior economists and officials at Deutsche Bank, Goldman Sachs, the European Central Bank (ECB), and the German Council of Economic Experts. Discussions ranged from recent actions by central banks to the health of the German economy.

DECOUPLING: NOT IF, BUT HOW MUCH

¶3. The theory that Germany's investment in and trade with new markets has reduced its once great reliance on exports to the U.S. has gained prominence in Germany and is commonly referred to as "decoupling." Nonetheless, a senior economist at Deutsche Bank argued that, with the U.S. economy representing one quarter of world GDP, a slowdown was certain to have an effect on Germany, the world's largest exporter. Although the Bundesbank recently indicated that German exports remained strong and would continue to do so, he argued that exports both to the U.S. and dollar-linked economies in the developing world would naturally decline by the end of the year, with a knock-on impact on overall growth. The favorable news on current exports would disappear once the impact of the strong euro and the global slowdown appeared.

¶4. On the other hand, Goldman Sachs's chief economist argued that decoupling was here to stay. Germany's exports to the developing world, especially to Brazil, Russia, India and China (the so-called BRIC countries), are expanding rapidly, while those to the U.S. represent a diminishing share of total trade. Trade figures published by the German statistical office seem to prove the point: From 2006 to 2007, German trade with the BRIC countries increased 15% from 63.1 billion euros ($99 billion) to 72.3 billion euros ($114 billion), now almost on a par with the 73.4 billion euros ($116 billion) of goods exported to the U.S., down from 77.9 billion euros ($123 billion) in 2006.

¶5. Economists at the German Council of Economic Experts, a

prominent advisory body to the German government, agreed that the economy looked strong for 2008. High-quality German industrial products, from machine tools to electronics, continue to be in high demand worldwide. Competing on quality and reliability, rather than price alone, German sales are only marginally affected by the strong euro which may even help German firms gain a competitive edge on price-sensitive European competitors. They also expect the effect of the subprime crisis on Germany to be limited since German enterprises traditionally rely heavily on their own capital resources and are therefore not as dependent on external credit. In addition, they said the slowdown in the U.S. economy was sector-based focusing on areas such as construction that do not rely heavily on imports.

BANKING SECTOR: NERVOUS WAIT FOR NORMALITY TO RESUME
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¶6. European Central Bank (ECB) officials confirmed that interbank lending remained abnormal in Germany and Europe, with three-month rates still far above the official ECB rate. The ECB on March 25 allotted an extra 50 billion euros ($77.1 billion) in short-term credit as part of its weekly refinancing operation. The bank announced March 28 it would provide 150 billion euros ($237 billion) in additional liquidity, which would include its first ever six-month refinancing operations, with three transactions at 25 billion euros ($40 billion dollars) starting April 3.

¶7. Officials at the ECB argued that recent operations were driven primarily by banks' need for liquidity at the end of the reporting cycle, and reflect somewhat normal circumstances. Private bank economists said that Spanish banks were large demanders of ECB credit. ECB officials said that their acceptance of a wide range of collateral and a large set of counterparts in monetary operations, two practices that the U.S. Federal Reserve is reportedly now moving closer toward, have been keys to the successful response to the lack

of liquidity.

¶8. The officials emphasized the difference in conditions in the U.S. and European financial markets in the current crisis saying of the U.S. "Who knows what we would have done?" and drawing a clear line between the interest rate policies of the Federal Reserve and the ECB. Apart from the obvious difference in mandate, with the ECB primarily committed to price stability, officialssaid that they saw a different economic environmnt in Europe, with euro-zone inflation at a recod high of 3.3% in February and oil prices and demad both strong. For Germany, the ECB expects excetional wage growth in 2008 despite increased dowward risks. When coupled with rising inflation,the ECB has little choice but to keep interest rats up. The Deutsche Bank economist even worried aout possible "stagflation" -- stagnation in Europan economies and rampant inflation in the develoing world -- and said that the key was for the EB to hold firm on interest rates.

¶9. The healt of the German banking sector was again questioned this week as greater than expected write-downs emrged from state banks BayernLB and WestLB (4.3 bllion euros or $6.7 billion, and 1.6 billion eurs or $2.5 billion respectively). Moreover, Deutsce Bank stepped back this week from profit target of only a month ago and reported expected write-owns in its leverage loan portfolio of 2.5 billin euros ($4.0 billion) in the first quarter of 200. The Deutsche Bank economist said his bank hadadjusted too slowly to new circumstances and, lie others, had not generated a new business model nd now faced a deteriorating revenue stream. On te accounting side, he said the "mark to market" system has not worked well in a dysfunctional market where current prices do not reflect the true value of assets, and write-downs have a multiplier effect as banks unravel holdings. Several experts wondered when cash-rich sovereign wealth funds would step in to buy up undervalued assets, seeing such a development as only a matter of time. The Goldman Sachs economist predicted that German banks would leave capital markets and return to their core business: private lending.

¶10. A number of interlocutors speculated on the need for new regulation. ECB officials echoed ECB President Jean Claude Trichet's testimony before the European Parliament on March 26 in

which he pointed to the need for new regulation to be anti-cyclical. Present rules, they claim, have exacerbated problems rather than prevent them. Rules kicked in when it was too late and are partly to blame for the downward spiral experienced in financial markets. One economist proposed that asset values should be included in the calculation of interest rates by central banks to prevent bubbles resulting from artificially low rates. Private bank economists agreed that new rules on liquidity requirements for the financial sector were necessary.

¶11. COMMENT. While projections for 2008 point to continued growth of the German economy, all forecasters have revised their expectations downward, lower than the government's prediction of just below 2%. Despite strong fundamentals, downward risks loom: a strong euro, above-target inflation, and demand for large wage increases. While central bankers deserve credit for maintaining macroeconomic stability to date, financial markets remain unsteady. "This is not a textbook situation," the ECB's chief economist said in describing the current state of affairs. END COMMENT.

¶13. This cable was coordinated with Embassy Berlin.

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